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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 452

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES T. FISHER, EDWARD F. FISHER, AND LEO
M. BUTZEL, EXECUTORS OF THE ESTATE OF FRED
J. FISHER, AND BURTHA M. FISHER

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH
CIRCUIT

The Acting Solicitor General, on behalf of the
Commissioner of Internal Revenue, prays that a
writ of certiorari issue to review the judgment of
the United States Circuit Court of Appeals for
the Sixth Circuit entered in this case.

OPINIONS BELOW

The memorandum opinion of the Tax Court
(R. 141-143) is unreported. The opinion of the
Circuit Court of Appeals (R. 151-154) has not
yet been reported.

JURISDICTION

The judgment of the Circuit Court of Appeals
was entered on June 25, 1945 (R. 160). The juris-

diction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the decision of the court below conflicts with the decision of this Court in *Commissioner v. Wheeler*, decided March 26, 1945.

STATUTES AND OTHER AUTHORITIES INVOLVED

The provisions of the statutes and other authorities involved are set forth in Appendix A, *infra*, pp. 16-24.

STATEMENT

The facts in this case were stipulated by the parties (R. 15-26, 141). Senior Investment Corporation, a Michigan corporation, was incorporated on July 29, 1929, with an authorized capital of 300,000 shares of no par value stock consisting of 100,000 shares each of Class A, B, and C stock (R. 16, 141). Taxpayer¹ and his wife were among the incorporators (R. 16). On July 29, 1929, immediately following incorporation, in exchange for the issuance of Senior Investment Corporation stock, they transferred certain se-

¹ For convenience, Fred J. Fisher will be referred to as the taxpayer, although he and his wife, Burtha M. Fisher, filed a joint return for 1934, the taxable year in controversy. Fred J. Fisher died subsequent to the filing of the petition before the Tax Court seeking a redetermination of the deficiency found by the Commissioner, and the executors of his estate were substituted as petitioners. (R. 14, 15.)

curities to the corporation (R. 17). The cost to taxpayer and his wife, and the fair market value, as of July 29, 1929, of the securities transferred, and the shares of its stock issued by Senior Investment Corporation in exchange, are as follows (R. 17-18, 142):

| | Cost | July 29, 1929, fair market value | Shares of Senior In- vestment Corpora- tion stock issued |
|------------------|-----------------|----------------------------------------|----------------------------------------------------------------|
| Fred J. Fisher | \$12,957,242.88 | \$42,943,427.76 | 71,773 Class A, 79,805 Class C. |
| | 894,000.02 | 30,000,000.00 | 100,000 Class B. |
| Burtha M. Fisher | 699,350.00 | 5,486,250.00 | 9,143 Class A, 10,195 Class C. |

The remaining 10,000 shares of Class C stock were issued to an employee without any payment (R. 17, 142). On December 9, 1931, the Class A stock which had been issued to taxpayer's wife was retired and thereafter taxpayer held all the outstanding Class A and Class B stock (R. 19, 142).

On January 31, 1934, gain or loss from the sale or other disposition of the assets exchanged for stock on incorporation would, if computed on the basis of the transferors' cost of those assets, have resulted in Senior Investment Corporation having an adjusted surplus in excess of \$1,723,881.25 available for the distribution of dividends (R. 20-25, 142). In computing its taxable income, Senior Investment Corporation had determined its federal tax liability by using the transferors' cost (R. 25): However, if gain or loss were com-

puted by using the fair market value of those assets as of the date they were exchanged for its stock, Senior Investment Corporation would have had an operating deficit as of January 31, 1934 (R. 20-25, 142).

On January 31, 1934, taxpayer, without surrendering any of his Class A stock in Senior Investment Corporation, received a distribution thereon consisting of 43,300 shares of common stock of General Motors Corporation. The General Motors shares had a value, as of that date, of \$1,723,881.25 (R. 15-16, 141). Taxpayer and his wife filed a joint return for 1934 but did not include in their taxable income the amount of the above-mentioned distribution (R. 16). The Commissioner determined that the distribution constituted a dividend received by taxpayer from Senior Investment Corporation and that it should have been included in his taxable income (R. 16). Consequently, he found a deficiency in income tax of \$1,231,636.92, the greatest portion of which was attributable to the failure to have included the distribution of General Motors stock in taxpayer's taxable income (R. 8-14, 141).

On September 6, 1940, taxpayer filed a petition with the Board of Tax Appeals (now the Tax Court of the United States) for a redetermination of the deficiency on the ground that the distribution constituted a return of capital which served to reduce, but which was not in excess of,

the cost basis of his Senior Investment Corporation stock (R. 3-7).

The Tax Court decided that the distribution did not constitute a taxable dividend since the corporation had a deficit in earnings and profits, it being held that the fair market value of the assets on the date of their exchange was the proper basis for computing earnings and profits (R. 141-143). The decision of the Tax Court, entered March 23, 1944, determined a deficiency of \$212,716.47, which arose out of matters not here in dispute (R. 143).

On review, the Circuit Court of Appeals issued an opinion on March 26, 1945, holding that the Commissioner's regulations were invalid if construed as requiring that earnings and profits be computed on the transferors' basis (Appendix B, *infra*, pp. 25-32). On May 7, 1945, the Circuit Court of Appeals granted the Commissioner's petition for a rehearing (R. 160). On June 25, 1945, the Circuit Court of Appeals issued a decision which amended its former opinion but which adhered to its previous disposition of the case (R. 160-161).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred in deciding that the corporation here involved was not required to compute its earnings and profits in relation to the transferors' basis for certain assets acquired in

a tax-free transaction, and that the corporation did not have sufficient earnings and profits for a distribution (which it made to the taxpayer) to constitute a taxable dividend.

REASONS FOR GRANTING THE WRIT

The ultimate issue in this case is identical with that decided in *Commissioner v. Wheeler*, No. 354, October Term, 1944, decided March 26, 1945, not yet reported. We maintain that the decision of the Circuit Court of Appeals in the present case is in direct conflict with the *Wheeler* case.

This case and the *Wheeler* case involve the computation of corporate earnings and profits on the disposition of assets acquired in a tax-free transaction. The *Wheeler* case held that, under a substantially identical regulation to that involved here, any increment in earnings and profits is to be measured in relation to the transferor's basis for those assets (just as corporate taxable gains are measured) and that the market value of the assets when acquired by the corporation must be disregarded. The court below, however, refused to use the transferors' basis to determine the amount of earnings and profits available for the distribution of a corporate dividend in this case but, instead, relied on the market value of the transferred assets. Its decision, in effect, repudiates the *Wheeler* case and the grounds on which that decision rests.

On the same day that *Commissioner v. Wheeler*, *supra*, was decided, upholding the Commissioner's regulation which required that the transferor's basis be used, the court below handed down its first opinion in this case (set forth in full in Appendix B, *infra*, pp. 25-32) holding Article 115-1 of Treasury Regulations 86 (Appendix A, *infra*, pp. 20-21) invalid if construed to require the use ~~for~~ ^{the} transferors' basis.

After granting a rehearing because of the asserted conflict with the *Wheeler* case, the court below decided that it would adhere to its original disposition of this case. Its previous opinion was withdrawn and a second opinion was rendered to justify the result reached. Withdrawing from its previous position that Article 115-1 was invalid, the court nevertheless attempted to distinguish the *Wheeler* case and refused to apply the regulation on the ground that it was rendered inoperable here by Section 501 (c) of the Second Revenue Act of 1940 and T. D. 5024 (Appendix A, *infra*, pp. 20, 21-24), since the present case was pending before the Tax Court (then the Board of Tax Appeals) on September 20, 1940. We believe that there are no material distinctions between the instant case and the *Wheeler* case, and that the decision of this Court was actually nullified by the court below.

(a) One of the reasons apparently relied on by the court below for making the pending dates

of the two cases a source of distinction,² and for not applying the regulatory provisions which were approved in the *Wheeler* case, is Section 501 (c) of the Second Revenue Act of 1940 (Appendix A, *infra*, p. 20) which provides:

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were made a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

The *Wheeler* case, however, demonstrates that the attempted distinction is without meaning. The very issue in that case was whether Section 501 (c) was valid in requiring, as the taxpayer there contended, the retroactive application of a new rule for the computation of earnings and profits. This Court, however, held that Section 501 (a) (Appendix A, *infra*, p. 18) did not enact, and that Section 501 (c) did not retroactively apply, a new rule; on the contrary, it was

² In the *Wheeler* case, the petition was filed with the Board of Tax Appeals on May 12, 1941 (Record in No. 354, October Term, 1944, p. 1); in the instant case, the petition was filed with the Board on September 6, 1940 (R. 3).

held that the rule contended for by the Commissioner had already been provided for by Section 111 (c) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and by Article 115-3 of Treasury Regulations 101, promulgated under the Revenue Act of 1938. Accordingly, it was concluded that "There is no necessity to predicate the determination of deficiency on the 1940 amendment" (slip op. 4). In the present case, Section 111 (c) of the Revenue Act of 1934 and Article 115-1 of Treasury Regulations 86 (Appendix A, *infra*, pp. 16-17, 20-21), which are substantially identical with those involved in the *Wheeler* case, required the use of the transferors' basis; in the present case, also, there is no necessity of predicating the method of computation on the provisions of the Second Revenue Act of 1940.

Thus, whether this case was pending on September 20, 1940, is not a material distinction from the *Wheeler* case; in both cases the rule of computation applied is not based on Section 501 and nothing in Section 501 (c) is used or relied on to "affect the tax liability of any taxpayer." The tax liability here results from the provisions of the statute and regulations in effect in 1934. In refusing to give effect to those provisions, the Circuit Court of Appeals clearly contradicted a controlling decision of this Court. This negation of the *Wheeler* case is even more emphatic when it is realized that the court below, in using market

value as the basis, persisted in applying a rule which was expressly rejected by this Court and which, as this Court stated, resulted from using "as a base for tax purposes a figure that in itself had no relation to taxation" (slip op. 3).³

(b) The other reason relied on by the Circuit Court of Appeals for making the pending dates of the two cases a source of distinction rests on the provisions of T. D. 5024, 1940-2 Cum. Bull. 110 (Appendix A, *infra*, pp. 21-24). We submit that the Treasury Decision expressly provides that cases of this sort are to be governed by the rule applied in the *Wheeler* case. Paragraph 2 of

³ The Tax Court had expressly interpreted Section 501 as adopting a new rule which would result in affecting tax liability and which was, therefore, prohibited by Section 501 (c) from being used in pending cases. That was the basis for its decision in this case (R. 142-143), in the related case of *Senior Investment Corp. v. Commissioner*, 2 T. C. 124, 139 (now pending in the Circuit Court of Appeals for the Sixth Circuit), and also in *Falkland Corp. v. Commissioner*, decided November 8, 1941 (1941 P-H Memorandum Decisions, par. 41,497); cf. *Estate of Wheeler v. Commissioner*, 1 T. C. 640, 645, *et seq.* However, the decision of this Court in the *Wheeler* case clearly demonstrated that this reasoning had been in error. Also, the Tax Court felt it necessary, in order to prevent the application of a new rule, to adhere to its previous decisions which had used market value. Since the *Wheeler* case expressly repudiated these decisions, the reasons relied on by the Tax Court for using market value in pending cases were deprived of all validity. While the Circuit Court of Appeals in this case was not explicit in its construction of Section 501 (c), it reached the same erroneous result as the Tax Court.

T. D. 5024, which construes Section 501 (c) of the Second Revenue Act of 1940, provides:-

PAR. 2. The above amendments to Regulations 103 (which regulations cover taxable years beginning after December 31, 1938) are hereby made applicable to taxable years beginning prior to January 1, 1939 (such years being covered by Regulations 101, 94, 86, 77, 74, 69, 65, 62, 45, and 33). Although under section 501 (c) the final determination by the Board of Tax Appeals or any court of the United States of the tax liability of any taxpayer for any such taxable year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States, is not affected by the enactment of section 501, *the rules stated in the regulations are applicable to such cases inasmuch as such rules are a proper interpretation of the law as it existed prior to the enactment of section 501.* The limitation in section 501 (c) has application only to such taxpayer, and in the case of such taxpayer, only with respect to the tax liability for the specific year or years actually so pending on, or so determined prior to, September 20, 1940. [Italics supplied.]

It is difficult to conceive how the italicized language could have expressed more clearly the proposition that use of the transferor's basis had always been the proper rule for the calculation of

earnings and profits and was to be applied to pending cases on account of that, and not because of the enactment of the Second Revenue Act of 1940. That was the position which was consistently adhered to by the Commissioner and which was accepted as the basis for the decision in the *Wheeler* case.

The last sentence of paragraph 2 of T. D. 5024 was construed by the court below as contradicting the preceding sentence. However, we believe that the last sentence merely states a conclusion, which had been more fully expressed in the committee reports,* that, if there should be an erroneous final decision in favor of a particular taxpayer in a case pending on September 6, 1940, or already decided, the finality of the decision would be limited to the particular year involved and *res judicata* would not operate to give him (or other stockholders in the same corporation) a vested right in the wrong method of computing earnings and profits for all other taxable years. Such a precautionary statement does not mean that the correct method of computation must not be applied in a case pending on September 6, 1940, and that resort must be had to an erroneous method instead. In any event, the last sentence of the Treasury Decision has no application here, for it involves Section 501 (c).

* S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 26-27 (1940-2 Cum. Bull. 528); H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 61-62 (1940-2 Cum. Bull. 548).

which, as we have shown, does not affect the tax liability in this case.

The court below advanced only one explicit reason for its belief that the Commissioner intended to insulate pending cases from the application of the correct rule. It was suggested that, having first adopted the use of the transferor's basis in the regulation here applicable (Article 115-1 of Treasury Regulations 86), and having promulgated the regulation after the beginning of the taxable year 1934, the Commissioner wished to avoid a retroactive application thereof. We deny that any retroactivity is involved in this or in other cases involving the tax year 1934. In the *Wheeler* case, it was stated that "Congress appears to have provided" for the use of the transferor's basis in Section 111 (c) of the Revenue Act of 1938 (slip. op. 4). Similar provisions have appeared in all Revenue Acts beginning with Section 202 (d) of the Revenue Act of 1924, c. 234, 43 Stat. 253.⁵ Moreover the regulation only clarified existing statutory language.

The assumption that the Commissioner wished to avoid a retroactive application of Article 115-1 embodies a *non-sequitur*. If a case was pending on September 20, 1940, or had previously been decided, there is no relationship

⁵ See Section 202 (d) of the Revenue Act of 1926; Section 111 (d) of the Revenue Act of 1928; Section 111 (c) of the Revenue Acts of 1932, 1934, 1936, 1938 and of the Internal Revenue Code.

between that fact and the precise year in which the disputed earnings and profits arose. Thus *Falkland Corp. v. Commissioner*, decided November 8, 1941 (1941 P-H Memorandum Decisions Service, par. 41,497), footnote 3, *supra*, although pending on September 20, 1940, involved the tax year 1937 and retroactive application, even under the court's theory, could not have been presented in that case. Also, it would be possible for the tax year 1934 to be involved in cases filed after September 20, 1940. If the Commissioner had actually intended the result which the court relied on, and if he had possessed the authority to do so, Treasury Regulations 86 would have been amended to exempt the year 1934. Making an exception for cases pending on September 20, 1940, could scarcely have been expected to accomplish this except by the process of coincidence.

It can only be concluded that the decision in this case, and the reasons apparently relied on by the court below in support of its decision, conflict in all respects with the decision of this Court in *Commissioner v. Wheeler*, *supra*.

In failing to accept the *Wheeler* decision as controlling, the court below has so far departed from the usual course of judicial proceedings as to call for this Court's supervisory review.⁶

⁶ Unless reversed, the court below will undoubtedly adhere to its present holding in deciding the similar issue in *Senior Investment Co. v. Commissioner*, fn. 3, *supra*.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

HAROLD JUDSON,
Acting Solicitor General.

SEPTEMBER 1945.

APPENDIX A

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the

purposes of this title, shall be determined under the provisions of section 112.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as herein-after provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(6) *Tax-Free Exchanges Generally.*—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain

or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made.

* * * This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

(8) *Property Acquired by Issuance of Stock or as Paid-In Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

“(1) Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

“(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

“(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year

in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

“(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

“(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received. * * *

(b) *Effective Date of Amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States. (26 U. S. C. 1940 ed., Sec. 115.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 115-1. *Dividends.*—The term “dividends” for the purpose of Title I (except when used in sections 203 (a) (4) and 207

(c) (1) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. Among the items entering into the computation of corporate "earnings or profits" for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section: * * *

T. D. 5024, 1940-2 Cum. Bull. 110:

PARAGRAPH 1. By reason of the enactment of section 501 of the Second Revenue Act of 1940 (Public, No. 801, Seventy-sixth Congress, third session), approved October 8, 1940, Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] are amended as follows: * * *

C. The following sections are inserted immediately following section 19.115-11:

SEC. 19.115-12. *Effect on earnings and profits of gain or loss realized after February 28, 1913.*—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (1) prescribes certain rules for (1) the computation of the total earnings and profits of the corporation, of most frequent application

in determining invested capital; and (2), the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of Chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and profits accumulated after February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning after February 28, 1913, the determination of either must be in accordance with the rules herein prescribed for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under (1) such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but disregarding value as of March 1, 1913. Under (2) there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. In both cases the rules are the same as those governing depreciation and depletion in computing earnings and profits (see section 19.115-3). Under both (1) and (2) the adjusted basis is subject to the limitations of the third sentence of section 115 (1) requiring the use of adjustments proper in determining earnings and profits. The proper adjustments may differ under (1) and (2) of section 115 (1) depending upon the basis to which the adjustments are to be made. If the application of (2) of the

first sentence of section 115 (1) results in a loss and if the application of (1) of such sentence to the same transaction reaches a different result, then the loss under (2) will be subject to the adjustment thereto required by section 115 (m)(2). (See section 19.115-14.)

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. * * *

* * * * *

PAR. 2. The above amendments to Regulations 103 (which regulations cover taxable years beginning after December 31, 1938, are hereby made applicable to taxable years beginning prior to January 1, 1939 (such years being covered by Regulations 101, 94, 86, 77, 74, 69, 65, 62, 45, and 33). Although under section 501 (c) the final determination by the Board of Tax Appeals or any court of the United States of the tax liability of any taxpayer for any such taxable year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States, is not affected by the enactment of section 501, the rules stated in the regulations are applicable to such cases inasmuch as such rules are a proper interpretation of the law as it

existed prior to the enactment of section 501. The limitation in section 501 (c) has application only to such taxpayer, and in the case of such taxpayer, only with respect to the tax liability for the specific year or years actually so pending on, or so determined prior to, September 20, 1940.

APPENDIX B

Opinion, rendered March 26, 1945.

Before HICKS, ALLEN, and MARTIN, Circuit Judges.

ALLEN, Circuit Judge. The principal question presented in this case is whether the taxpayer received in 1934 a taxable dividend paid out of earnings and profits of the Senior Investment Corporation. The Commissioner determined a deficiency of \$1,231,636.92, based primarily upon a distribution by the Senior Investment Corporation in 1934 of 43,400 shares of common stock of General Motors Corporation. The Tax Court held that the Senior Investment Corporation had a large operating deficit on the date of the distribution of the shares, and that no taxable dividend was received.

The material facts as stipulated and found by the Tax Court are as follows:

The tax return involved was made for 1934 as a joint return by Fred J. Fisher and his wife, Burtha M. Fisher, residents of Detroit, Michigan. In January 1934, Fisher owned all of the outstanding Class A shares of the Senior Investment Corporation, 71,573 in number. The cost to him of these shares was not less than \$1,723,881.25. On January 31, 1934, without surrendering any of the Class A shares Fisher received as a distribution on the stock 43,300 shares of General Motors common stock having a value of \$1,723,881.25. The Senior Investment Corporation was

incorporated July 29, 1929, with 300,000 shares of no par value stock, consisting of 100,000 shares each of Class A, B, and C stock. Immediately following the incorporation the Fishers transferred certain assets, particularly securities, to the Senior Investment Corporation. The cost to the Fishers and the July 29, 1929, fair market value of the assets transferred and the number of shares issued to them therefor by the Senior Investment Corporation are shown in the following table:

| | Cost | July 29, 1929 fair market value | Number of Senior Shares Issued |
|------------------------|-----------------|---------------------------------------|--------------------------------------|
| Fred J. Fisher | \$12,947,242.88 | \$42,943,427.76 | 71,573 Class A. 79,805 Class C. |
| Burtha M. Fisher | 894,060.62 | 40,000,000.00 | 100,000 Class B. |
| | 609,350.00 | 5,486,250.00 | 9,143 Class A. 10,195 Class C. |

The remaining 10,000 Class C shares were issued to an employee for no consideration. On December 9, 1931, the Senior Investment Corporation retired the 9,143 Class A shares held by Burtha N. Fisher.

In computing its gain or loss from the sale or other disposition of the assets received for its shares on incorporation the Senior Investment Corporation used as a basis the fair market value of such assets on the date received. As a result the corporation had a large operating deficit on January 31, 1934, when the General Motors Corporation shares were distributed to Fisher. The Commissioner used the transferors' costs as a basis, and thus computed, the books of the corporation showed a surplus in excess of \$1,723,-

881.25 available for distribution of dividends. Since Fisher did not receive a taxable dividend unless the Senior Investment Corporation had a surplus available for distribution of dividends, the case turns upon the question whether the corporation, in computing its gain or loss on the sale of the assets acquired by it from the Fishers in exchange for its own stock, should have used as a basis the fair market value of the assets at the time of the exchange, or the transferors' cost. The Tax Court, relying upon decisions of its own and of other courts [Cf. *Commissioner v. W. S. Farish & Co.*, 104 Fed. (2d) 833 (C. C. A. 5); *Commissioner v. F. J. Young Corp.*, 103 Fed. (2d) 137 (C. C. A. 3)], held that the basis used by the Senior Investment Corporation was correct and declined to sustain the deficiency.

The Commissioner contends that when a corporation acquires assets in a transaction where the transferors' gain or loss is not recognized for tax purposes, the corporation's earnings and profits for dividend purposes are determined in the same manner as its taxable gains. The transactions between the Fishers and the Senior Investment Corporation were tax free within § 112 of the Revenue Act of 1934. In order to sustain the contention that earnings and profits for dividend purposes in such a transaction are determined in the same way as taxable gains, the Commissioner relies upon Article 115-1 of Treasury Regulations 86, which in its material portion read as follows:

The term "dividends" for the purpose of Title I [except when used in sections 203 (a) (4) and 207 (c) (1)] comprises any distribution in the ordinary course of busi-

ness, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. Among the items entering into the computation of corporate "earnings or profits" for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section * * *

We think the decision of the Tax Court must be affirmed not only upon the authority of the cases cited, but for the reason that Article 115-1 of the Treasury Regulations is invalid if applied to this transaction as the Commissioner contends.

The statute which governs this situation was first enacted in 1940 and its material portions are printed in the margin.¹ This section in effect pro-

¹ Second Revenue Act of 1940, c. 757, 54 Stat. 1004.

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) Under Internal Revenue Code, Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(1) Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions. The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the

vides that corporate earnings and profits on the sale of assets of the corporation are to be computed in the year when recognized in the same manner as taxable gains are calculated. But the statute also provides that the amendments made by the section shall not affect the tax liability of any transferor for any year which on September

year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain."

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, when the latter adjustment shall be used in determining the increase or decrease above provided * * *

(b) *Effective Date of Amendment.* The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.* For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

20, 1940, was pending before or was theretofore determined by the Board of Tax Appeals or any court of the United States. The petition in this case was filed September 6, 1940, and therefore the proceeding is not governed by the amendments of 1940.

Article 115-1, quoted above, was promulgated under the Revenue Act of 1934, and the Commissioner contends that the basis specifically made applicable to the transactions involved here is cost in the hands of the transferor through the provision that "Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section." While mentioned by the Tax Court, this regulation was not considered in the opinion.

Section 112, referred to in the regulation, provides that upon sale or exchange of property the entire amount of the gain or loss determined under § 111 shall be recognized. Section 111 states that the gain from the sale or other disposition of property shall be the basis of the amount realized therefrom over the adjusted basis provided in § 113 (b) for determining gain. The provision of § 113 (a) (B) is that if the property was acquired by a corporation after December 31, 1920, as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor.

Assuming, but not deciding, that Article 115-1 requires the use of cost to the transferor as the basis for calculating gain or loss, we think that

the decision of the Tax Court still must be affirmed upon the ground that the regulation, if so applied to the transaction, would not be valid. Since no statutory provision existed in 1934 covering the basis to be used in determining earnings and profits, that provision could not be supplied by administrative regulation. The regulation construed here as the Commissioner contends in effect amends the statute, for it adds a provision not in the statute itself. This cannot be done. *Morrill v. Jones*, 106 U. S. 466, 467; *Miller v. United States*, 294 U. S. 435, 439; *Allis v. La Budde*, 128 Fed. (2d) 838, 840 (C. C. A. 7); *Commissioner v. Commodore, Inc.*, 135 Fed. (2d) 89 (C. C. A. 6). The authority given the Secretary of the Treasury for promulgation of regulations is found in § 4041 of the Internal Revenue Code, which provides that regulations may be promulgated for the purpose of execution and enforcement of the revenue laws. But Article 115-1, if construed as the Commissioner contends, goes far beyond enforcement. It constitutes administrative legislation.

We see nothing in *Commissioner v. Sansome*, 60 Fed. (2d) 931 (C. C. A. 2) requiring a contrary conclusion. That case held that amounts conceded to be prior earnings and profits of a transferor corporation constituted earnings and profits in the hands of the transferee corporation. No question of the transfer of assets by individuals to a corporation and no question whether gains from such a transaction should be figured upon the same basis as earnings and profits were involved in that case.

Since the amendment of 1940 by express terms does not govern this case, and since Article 115-1 cannot properly be applied to the transaction, we think that the reasoning of *Dobson v. Commissioner*, 320 U. S. 489, 502, squarely governs. No clear-cut mistake of law appears, and the decision of the Tax Court is affirmed.